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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 948 24

MARINE HARBOR PROPERTIES, INC.,
Petitioner,

vs.

MANUFACTURER'S TRUST COMPANY, (successor by merger to the Mortgage Corporation of New York), as trustee for the benefit of certificate holders in mortgage guaranteed by Bond & Mortgage Guarantee Company, Guarantee #181,568,

MAURICE RUBINGER, trustee of Marine Harbor Properties, Inc.,

SAMUEL SILVERMAN, additional trustee of Marine Harbor Properties, Inc.,

MORTIMER RUBENSTEIN, Foreclosure-receiver,

and

SECURITIES AND EXCHANGE COMMISSION.

BRIEF IN SUPPORT OF PETITIONER.

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and

SECURITIES AND EXCHANGE COMMISSION.

No. 948.

BRIEF IN SUPPORT OF PETITIONER.

Opinions Below.

The opinion of the District Court is contained in the record (R. 70-75). It is also reported in 41 Fed. Supp. 814 (S. D. N. Y.). The majority and dissenting opinions of the Circuit Court of Appeals are contained on Pages 107 to 131 of the record. They are also reported in 125 Fed. (2) 296 (advanced sheets).

Jurisdiction.

The jurisdiction of this court is invoked under Section 240 (A) of the judicial code as amended by the Act of February 13, 1925.

Statement.

The debtor is a New York corporation whose principal asset is an apartment building in New York City. Encumbering said asset is a first mortgage, which was originally held by the Title Guarantee and Trust Co., but this corporation sold it to the general public through certificates of participation therein. Payment of the principal and interest of said certificates of participation was guaranteed, however, by Bond & Mortgage Guarantee Co. (R. 8), also a New York corporation.

The depression that followed 1929 resulted in the insolvency of Bond & Mortgage Guarantee Co. In 1933, the Superintendent of Insurance of the State of New York, pursuant to an order of the Supreme Court of the State of New York, took possession of the property and business of the said Bond & Mortgage Co., in order to rehabilitate same (R. 8-9). Thereafter, the Superintendent of Insurance, acting under powers granted to him by the Schackno Act of the State of New York (Chap. 745, New York Laws, 1933), and with the approval of certificate holders and the State Court extended the maturity date of the said first mortgage and reduced the interest thereon from 6% to 5% per annum (R. 11).

In 1938, the Superintendent of Insurance was succeeded (R. 38-44) by the Mortgage Corporation of New York, who, pursuant to an order of the State Court, made and delivered a Declaration of Trust (R. 23-37). By the terms

of this instrument, there was vested in the said Mortgage Corporation of New York, certain enumerated powers to manage and control the first mortgage investment until it was fully liquidated (R. 38-44). When the said Declaration of Trust was approved, the State Court expressly reserved jurisdiction to grant other relief on the application of "the trustee or any other interested party" (R. 44). The respondent, Manufacturers' Trust Co., is the successor-by-merger of the Mortgage Corporation of New York (R. 3).

The principal of the first mortgage was not paid by the debtor at maturity and still remains unpaid, but foreclosure, because of said non-payment of principal, was suspended by special acts of the New York State Legislature. (Chap. 500, New York Laws 1938; Chap. 606, New York Laws 1939; Chap. 566, New York Laws 1940; Chap. 782, New York Laws 1941). The debtor remained in possession of its property and made all other payments until April, 1941, when it defaulted on interest and taxes (R. 12).

Upon such default, the Mortgage Corporation of New York commenced foreclosure proceedings (R. 12-13). During the pendency of those proceedings, the debtor offered the Mortgage Corporation of New York various proposals to extend and modify the terms of the mortgage, but these various proposals were rejected (R. 14). They never reached the State Court or the certificate holders for their consideration (R. 72).

On September 17, 1941, the debtor filed an *ex parte* petition for reorganization under Chapter X (R. 76). The petition was approved and reorganization trustees were appointed by the District Court (R. 96). The Mortgage Corporation of New York thereafter applied to the District Court to vacate the *ex parte* order of approval and to dismiss the petition as not filed in good faith (R. 7-21). This application was denied (R. 4-5) and an appeal (R. 3)

from the order denying such application was taken by the Mortgage Corporation of New York to the United States Circuit Court of Appeals for the Second Circuit. By a divided bench (R. 107-126), the Circuit Court reversed (R. 126) the order of the District Court.

Specifications of Errors to be Urged.

The majority of the Court below erred:

1. In holding that the Debtor's petition for reorganization under Chapter X of the Bankruptcy Act was not filed in good faith.

2. In holding that there was an absence of good faith on the part of the debtor because the debtor has assented to a modification and extension of a certificated mortgage in a State Court proceeding.

3. In failing to determine that the interests of creditors and stockholders would be better subserved in the State Court proceedings than in proceedings under Chapter X of the Bankruptcy Act, and that such State Court proceedings would not provide for public investors safeguards equivalent to those provided by Congress in Chapter X.

4. In holding that the State Court proceedings under the *Schackno Act* (Chap. 745, New York Laws of 1933) and the *Mortgage Commission Act* (Chap. 191 New York Laws of 1935) were "prior pending proceedings" within the meaning of *Section* 146 (4) of Chapter X.

5. In failing to affirm, and in reversing the order of the District Court.

Argument.

A summary of the points which are hereinafter made on behalf of the petitioner are:

I. The District Court properly refused to find that there were any prior pending proceedings wherein the interest of creditors and stockholders would be best subserved because (1) Schackno proceedings do not possess the power and safety of a proceeding under Chapter X, (2) they are not now "pending", and (3) in any event the respondent had the burden of proving that they would best subserve the interests of creditors and stockholders which burden the respondent has failed to sustain.

II. The debtor is not personally disqualified from invoking the jurisdiction of the Federal court under Chapter X of the Bankruptcy Act because the debtor never really invoked, or submitted to the jurisdiction of the state court, the debtor has no real standing in Schackno proceedings, and the debtor, as such, was never reorganized in, and is not now being supervised by the state court.

III. The Doctrine of Comity has no application to this case because the National Bankruptcy Act is paramount and superior to any local or state insolvency law, and the debtor has an absolute right to have its property administered under the Bankruptcy Act.

IV. Regardless of the personal disqualification of the debtor, it was error to dismiss its petition for reorganization in the interest of creditors because the protection of creditors' rights is superior to the interests of stockholders and no theory of estoppel or election of remedies should be permitted to deprive creditors of what is in their best interests.

POINT I.

The District Court properly refused to find that there was any prior pending proceedings wherein the interest of creditors and stockholders would be best subserved.

1. *Schackno proceedings do not possess the power and safety of a proceeding under Chapter X of the Bankruptcy Act.*

Schackno proceedings in the State of New York were born out of the depression that followed 1929. They were instituted to rehabilitate or liquidate various bond and mortgage companies that had become insolvent and defunct. They were special proceedings begun under a special act of the New York State Legislature, Chap. 745 New York Laws of 1933, and they became known as Schackno proceedings. They were always commenced by the State Superintendent of Insurance. The principal purpose of these proceedings was to protect the creditors of these insolvent and defunct bond and mortgage companies. Subdivisions 1 of the Schackno Act, *supra*. Thus it was the primary duty of the State Superintendent of Insurance (who has since been supplanted through various steps by the present respondent, sometimes referred to also as "Schackno Trustee") to administer, under the Schackno Act, *supra*, the mortgage investments of these defunct bond and mortgage companies in which groups of investors were interested, *People* vs. *Title & Mortgage Guarantee Co.*, 264 New York 69, at p. 92. In this way, Schackno proceedings were limited in their original nature, and in the extent of their jurisdiction. To date, there has been no change in or enlargement of their nature or the scope of their jurisdiction. They still suffer, as we shall show, from limitations in inherent power to

deal with situations and problems not within their purpose or jurisdiction.

Thus, in Schackno proceedings, property in the possession of the Superintendent of Insurance is not in *custodia legis*. *Acken* vs. *New York Title & Mortgage Co.*, 9 Fed. Supp. 521. A Schackno trustee does not ever acquire title to the property in which he is interested except through foreclosure or conveyance. Nor is a Schackno trustee, in Schackno proceedings, able to cope with a debtor's fraud or dishonesty. To do so, a wholly independent action must be instituted. *Weil, et al.* vs. *President and Directors of Manhattan Co.*, 275 New York 238. Neither does the Schackno trustee possess power to investigate and probe the debtor as to its past management or its future prospects. He remains as he was created, a purely statutory trustee, possessing only such power and authority as is conferred upon him by statute. *Weil, et al.* vs. *President, etc., supra*. *Wolff* vs. *Mortgage Commission, et al.*, 270 New York 428. Furthermore, in a Schackno proceeding, the Court cannot and does not possess jurisdiction over other creditors or junior lienors.

By contrast, the power and jurisdiction of a Chapter X proceeding stand out in bold relief. For when a debtor files a petition for reorganization, title to its property is immediately in *custodia legis*, thereafter vesting in the reorganization trustee upon his qualification as such (*Section 186*). Foreclosure thus becomes unnecessary. And if the debtor be dishonest or its officers be guilty of dishonesty, turn-over proceedings to recover the fruits of such dishonesty may be instituted within the very frame-work of a Federal reorganization. To investigate the debtor, its past management, and future prospects, the trustee has not only the power, but the affirmative duty to do so. (*Section 167*). Furthermore, it is beyond question that, in a Chapter X proceeding, the rights of all parties may be comprehensively examined, considered and dealt with.

Beyond these differences in inherent *power* as between a Chapter X proceeding and a Schackno proceeding, there are differences also in the nature and number of their *safety devices*. For the structure of Chapter X offers and provides protective devices (in cases where the liabilities exceed $250,000 as in this case) that are wholly absent in the state court reorganizations. These features are inherent in the nature and character of a Federal reorganization.

Thus, the reorganization trustee and his attorney must be disinterested (*Sections 156-8*). Upon appointment and qualification, he must investigate the debtor's property, the debtor's past management and operation, and the desirability of its continuance (*Section 167 (1)*). The trustee must also report to the court any fraud, misconduct or mismanagement (*Section 167 (3)*). The results of these beneficial investigations must then be sent to creditors and stockholders, who, upon such information, are asked to suggest proposals to be included in a plan (*Section 167 (5) (6)*). Before approving any plan, the District Court may seek the aid of the Securities and Exchange Commission for an advisory report (*Section 172*). Then, a hearing on a plan is had, on notice to all creditors and stockholders (*Section 171*). Solicitation of acceptances to a plan is prohibited until the District Court has approved the plan (See *Section 175*). And the District Court, before approving any plan, must first inquire as to its fairness, feasibility, and equitability. If no cash settlement is made, the court must examine into the new capital structure; make a finding that the earning capacity of the new enterprise will be sufficient to meet fixed charges; determine that the distribution of new securities reflects existing rights and are equitably treated. *Case* vs. *Los Angeles Lumber Co.*, 208 U.S. 106; *Consolidated Rock Products Co.* vs. *DuBois*, 61 Sup. Ct. 675. Then after all of this preliminary work has been accomplished

and the plan has been thus scrutinized by the District Court, (which is usually assisted by the Securities and Exchange Commission) it is submitted, with other available data and reports, to the interested parties, for their consideration (*Section 175*). When the plan has been accepted by the necessary majorities, a hearing is held for its confirmation upon due notice to all creditors and stockholders (*Section 179*). If the plan is fair, equitable and feasible, and its proposal and acceptance are in good faith and not in violation of any of the prohibitions contained in the Act, it will be confirmed (*Section 221 (2)*). Still, the Courts' investigation does not stop. It is even directed to the methods whereby the management and personnel of the reorganized corporation are to be chosen in order to insure adequate representation for the interests of all creditors and stockholders (*Section 221 (5)*). To that end, the District Court may pass, after the consummation of the plan, upon the qualifications of the management, personnel and voting trustees, if any (*Section 216 (11)*). In all of these ways, every possible conceivable safeguard has been provided by Congress for the protection of every class.

The Schackno Act, on the other hand, does not provide for corresponding safeguards. Particularly is it lacking in a device whereby creditors, secured or unsecured, as well as the stockholders, must receive a full and impartial report from a disinterested trustee, or the Security and Exchange Commission.[1] Neither is there a requirement

[1] It is contended that in state court procedures, there is such a safeguard in the form of the Bureau of Trust Supervision, an agency allegedly created by Chapter 740 of the Laws of 1940, New York, amending Section 17-a of Chapter 19 of the Laws of New York, 1935. However, the record fails to disclose any evidence showing the nature of the duties and obligations of this alleged agency, the facilities it has to properly assist and advise the Court and creditors on proposed plans, or a history of achievement in the field of reorganization.

that a plan must receive the preliminary approval of the court before consents may be solicited. Nor is there a provision for the mandatory application of the doctrine laid down in *Case* vs. *Los Angeles Lumber Products Co., supra.*

But beyond these limitations in the inherent jurisdiction, power and safety of Schackno proceedings is the plain fact that such proceedings, however good they may be, concern themselves solely with the assets of, and claims against insolvent and defunct guaranty companies. Schackno proceedings do not, nor can they, concern themselves with the problems of other debtors, such as the debtor herein, and the junior lienors. Thus, a person owning a chattel mortgage on the property of the debtor is not considered to be, nor is he, within the power and scope of a Schackno proceeding. Therefore, a debtor may be compelled to deal with one class of creditors in a Schackno proceeding, and another class of creditors in another proceeding. Hence, a multiplication of suits and proceedings would depend only upon the number of the debtor's other liabilities. This multiplicity of suits is impossible in a Federal reorganization.

It is contended that a debtor, whose property is insufficient to meet the obligations of the first mortgage, being therefore bankrupt, is not to be heard to complain about a possible multiplicity of suits. But solvency is not a prerequisite in a petition for reorganization. *In re: Central Funding Corp.*, 75 Fed. (2) 256. "In all reorganizations the debtor must be insolvent in one sense or another." * * * and that accordingly a "debtor can be reorganized though its equity has lost all value." *Central Hanover* vs. *President, etc.*, 105 Fed. (2) 130. Insolvency alone is not "sufficient to prove that the petition was filed in bad faith" *Majority opinion*, R. 108-109, citing in support. *In re: Castle Beach Apartments*, 113 Fed. (2) 762 (C. C. A. 2); *In re: Julius Roehrs Co.*, 115 Fed. (2) 723 (C. C. A. 3).

The insolvency of the debtor is undoubtedly an important factor to be considered by the District Court upon the presentation of a petition. But the final consideration of the debtor's insolvency is a matter that the District Court, after its initial or preliminary determination has been made, takes up for such final determination after the debtor has proposed a plan wherein it seeks to participate. If the debtor fails to furnish additional consideration "to justify a retention of a stock interest by the present stockholders of the debtor" (*Price* v. *Spokane Silver & Lead Co.*, 97 Fed. (2d) 237, at p. 245) then the whole proceedings may be dismissed as showing a lack of good faith. But this proceeding has not reached that stage. "It is a familiar rule that the court will not anticipate the decision of a constitutional question upon a record which does not appropriately present it." *Tennessee Publishing Co.* v. *American National Bank*, 299 U. S. 18.

Thus, whether or not a debtor is solvent when it files a petition for reorganization, should not control or determine its good faith. For a debtor may acquire an interest in an insolvent estate, by making a capital contribution thereto, complying in this way, with the basic and salutary rule laid down by this Court in *Case* vs. *Los Angeles Lumber Products Co., supra.*

2. *There is no prior proceeding "pending" within the meaning of Section 146 (4) of the Bankruptcy Act.*" This is disclosed first by the wording of the order of the state court which terminated all of the prior pending proceeding therein, and second by the statutes of the State of New York.

The state court order, by its own terms, was a "final" order. It was intended to, and it actually did terminate all prior pending state-court proceedings. But the true import of this "final" order is to be derived from a reading of the New York statutes governing the procedures

whereby a new proceeding could be commenced. The Mortgage Commission Act, *supra*, was amended to provide procedural requirements whereby new proceedings could be instituted. Under Chapter 290 New York Laws 1935 (Section 1957, McKinney's Unconsolidated Laws of New York), whenever the *Mortgage Commission* (here the Schackno trustee) desires to make any proposal in exercise of any of its limited powers,

> "it shall file a copy of such proposal with the Clerk of the Court and shall prepare and mail to each holder of a mortgage investment * * * a summary of such proposal together with a notice designating a date when such court (State Court) will pass upon such proposal and hear any objection thereto on the part of any holder of a mortgage investment."

The Schackno Act, *supra*, under which the Superintendent of Insurance took possession of the defunct Bond & Mortgage Guarantee Co., was also later amended to provide similar procedural requirements whereby a *certificate holder* could initiate a new proceeding (Chap. 906 New York Laws of 1934; *Section 1801 (1-a)* of McKinney's Unconsolidated Laws of New York). The difference between these two statutes is that the first was intended to apply only to new proceedings initiated by *Schackno Trustees*, while the other governed new proceedings initiated by *certificate-holders*.

The procedural requirements of the aforesaid statutes, closely scrutinized, clearly match the jurisdictional formalities usually present when any ordinary lawsuit is commenced. The new proceeding is commenced by the filing of a petition. (In an ordinary lawsuit, this would be the summons or citation.) Thereafter, notice by mail of the filing of such petition is given to all interested parties. (This is effecting service thereof.) After such

service has been effected, objections may be interposed in opposition to the petition. (This is the equivalent of an answer.) Thereafter, and as a result of the filing of objections, controverted issues of fact may arise which the state court may be required to determine. In such a case, the state court, "if it deems it necessary, may take testimony relative thereto." (Chap. 588, New York Laws of 1935; McKinney's Unconsolidated Laws of New York, *Section 1801*, Subd. 2.)

In the light of these statutes, the meaning of the state court's "final" order takes on its true significance. It terminated all prior proceedings in the state court for good and always, and unless the procedural requirements of these statutes were complied with, no proceeding could be deemed "pending".

* * * * *

3. *In any event, the respondent had the burden of proving that they would best subserve the interests of creditors and stockholders which burden the respondent has failed to sustain.* The motion to dismiss the debtor's petition was initiated by the respondent. When the respondent's motion came on to be heard before the District Court, there already existed a determination that the debtor's petition had been filed in good faith. That was a judicial determination of law and fact, even though made *ex parte*. *In re: Cheney Bros.*, 12 Fed. Supp. 609; *O'Connor* vs. *Mills*, 99 Fed. (2) 665 (C. C. A. 8); *In re: Augustyn*, 87 Fed. (2) 577 (C. C. A. 7). Therefore, it was the affirmative duty of the respondent to prove to the satisfaction of the District Court, a contrary situation, namely, that there was a "prior pending proceeding" within the meaning of *Section* 146 (4). This burden, it is respectfully submitted, the respondent has not sustained. Indeed, we may safely say that the respondent utterly failed in this respect. For the District Court, after studying all the

evidence before it and after hearing argument pro and con, concluded that

> "Such an object (Reorganization) cannot be attained in the State Court proceeding. It may be here" (R. 72).

This finding by the District Court was based upon, not only the statutory advantages of a Chapter X reorganization, discussed in Subd. 1 hereof, but also upon the fact that the Schackno trustee, under the Declaration of Trust (R. 85-86), possesses an interest adverse to all parties concerned, including the certificate holders. The District Court, undoubtedly bearing this in mind, commented on the resulting conduct of the Schackno trustee as follows: The debtor

> "endeavored on two separate occasions to present modified plans of relief *but on each occasion has been rebuffed by the (Schackno) trustee*" (R. 73). (Italics supplied.)

This result undoubtedly arose out of the fact that the Schackno trustee herein is entitled to receive a substantial sum of money each year as compensation for its services,[2] which income would cease if the debtor's petition were approved.

> "* * * it is appropriate to observe that it (Schackno trustee) had a selfish interest not identical with the interest of the certificate holders, in having the State Court proceeding continue because the (Schackno)

[2] By contrast, the State Superintendent of Insurance never was entitled to receive any income as a result of his participation in Schackno proceedings. Such participation was deemed part of his statutory duties.

trustee derived emoluments therefrom which would terminate if the Chapter X proceeding was not dismissed" (R. 113).

A further description of Schackno trustees is to be found in the recent case of *In re: Paloma Estates*,[3] where Judge Clark, dissenting, wrote,

> "And these (the facts) show that the trustees are now acting as dogs in the manger."

It was not inappropriate to observe therefore that perhaps this selfish interest has accounted for the failure of the Schackno trustee to apprize certificate holders of its opposition to the debtors application (R. 125).

The above determination of the District Court, that reorganization could not be accomplished in the Schackno proceeding, is final unless clearly shown to be wrong. For "the question of the good faith of a debtor is one of fact, the determination of which is by statute committed to the discretion of the District Court." * * * "His finding will not be set aside unless clearly shown to be erroneous." *O'Connor* vs. *Mills*, *supra*. There must be an abuse of discretion by the District Court to justify a reversal by the Circuit Court. *In re: Augustyn*, *supra*.

Since, in the instant case, there was a failure to show such an abuse of discretion, and because reorganization under Chapter X is vastly superior to a possible reorganization under the New York Schackno Act, *supra*, the District Court was correct in dismissing the respondent's motion. It follows therefore, that it was error for the Circuit Court to reverse.

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[3] *In the Matter of Paloma Estates, Inc.* (C. C. A. 2) decided February 21, 1942, unreported as yet. Opinions printed in brief of Securities & Exchange Commission offered in support of petition for Writ of Writ of Certiorari.

POINT II.

The debtor is not personally disqualified from invoking the jurisdiction of the Federal Court under Chapter X of the Bankruptcy Act.

The reversal of the District Court by the Circuit Court was on the ground of the alleged "personal disqualification of the debtor" to invoke a proceeding under Chapter X. This holding was based upon either or both of the following reasons: 1. the debtor's participations in the State Schackno proceeding, some seven years previous to its present application, in which previous proceeding the maturity date of the debtor's mortgage was extended and its interest rate was reduced, and or 2. the reservation of jurisdiction by the State Court as set forth in the "final order" (R. 44). In either case, or both, we believe that the holding of the Circuit Court was error.

1. The nature, extent and purpose of the debtor's participation in the State Schackno proceeding in the years 1934 and 1938 are contained in the record (R. 45-51; 52-54). It is a fact that nearly every property owner, whose property was encumbered by a certificated mortgage, participated to this extent in a State Schackno proceeding. *Report to His Excellency, Herbert H. Lehman, Governor, of the State of New York, by George W. Alger*, dated October 5, 1934. This participation was inevitable because during the last decade, nearly every certificated mortgage became due, and it was necessary to treat with the owners of such mortgage in order to satisfy the mortgage, (if possible), extend their dates of maturity, reduce their rates of interest and amortization, etc. Since the owners of the mortgage, in this case, were no longer represented by the Bond & Mortgage Guarantee Co., it was necessary to deal with a representative of said Bond

& Mortgage Guarantee Co. wherever he was to be found. That representative was, by special act of the New York Legislature, (Schackno Act, *supra*) the State Superintendent of Insurance, since supplanted through various steps, by the present respondent. Thus, if the Bond & Mortgage Guarantee Co. were not rendered insolvent, the consideration of the debtor's mortgage, *i. e.*, the maturity date, interest and amortization rates, etc., could be very well taken up in its old offices. There would have been no need to go to any court. But the Bond & Mortgage Guarantee Co. did not remain solvent, so that, when the debtor's mortgage approached maturity, the debtor was compelled to follow the Bond & Mortgage Guarantee Co., into the court where its representative was to be found. Thus, it was the insolvency of the Bond & Mortgage Guarantee Co., not the insolvency of the debtor, that pulled the debtor into the State Schackno proceeding. And this would be true also for the certificate holders, who, against their will, were likewise dragged into the State Schackno proceedings. Therefore, there is no significance to be attached to fact that the debtor may have initiated a motion in the State Schackno proceeding for the purpose of satisfying, modifying or extending its mortgage. The insolvency of the Bond & Mortgage Guarantee Co. made that step a compulsory act of the debtor. For the fact is that *the debtor was not being reorganized in the state court*. Only the representative of the certificate holders was being "reorganized".

The majority of the Circuit Court holds that since "the debtor made no attempt to bring its proposals to the attention of the state court" it is not entitled to invoke federal jurisdiction (R. 110) and that its prior holding in *Brooklyn Trust Co.* vs. *Rembaugh*, 110 Fed. (2) 838 requires that it be given effect here "to prevent a debtor who has assented to a plan which is being supervised by the state court in reorganization pro-

ceedings still pending there, from flouting that jurisdiction by filing a petition in the District Court" (R. 110).

The weakness of this argument is that the debtor has no real standing in Schackno proceedings for Schackno proceedings were instituted, as we have shown, not for the benefit of the debtor who has never been in bankruptcy or reorganization in any court, but in order to rehabilitate or liquidate defunct bond and mortgage guaranty companies. *People* vs. *Title & Mortgage Guarantee Co., supra.* And that is the reason why the Schackno and Mortgage Commission Acts (*Supra*) are so significantly silent as to methods and procedure whereby a *debtor's* proposal can ever reach the state court. That also is the meaning of Judge Clark's words, in his dissent[3] "for they (Schackno Trustees) will not present the debtor's revised plan to the state court, and *that appears to be the only way it can get there*"[3] (italics supplied). Clearly, the debtor is not a real party in interest in Schackno proceedings, for its problems are of no concern to the state court and are not within its jurisdiction.

The argument, *i. e.*, that there is a "plan which is being supervised by the state court", possesses several weaknesses. First is the simple fact that there is *no* plan at the present time. Whatever plan there *was*, expired by its terms in December, 1937. There is need now for a new plan because of changed circumstances. Secondly, neither the debtor nor the plan, as such, are being supervised. There can be no misunderstanding on this score. For the state court does not now supervise the debtor or the plan. It supervises merely the enforcement of the plan by the Schackno trustee, seeing to it that its obligations to the certificate holders are faithfully discharged. *Mortgage Commission Act, supra* Section 176[7].

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[3] *In the Matter of Paloma Estates, Inc., supra.*

McKinney's Unconsolidated Laws New York. And that is because the state Schackno proceedings do not have jurisdiction over any other person or property except the indenture (Schackno) trustee, the certificate holders, and the Mortgagee. It does not have original jurisdiction over the debtor. Thus, there can be no "flouting" of the state court's jurisdiction by the debtor, as the Circuit Court has held.

The contention, that the reservation of jurisdiction by the state court, as set forth in its "final order" (p. 44) was a personal disqualification of the debtor to invoke the jurisdiction of the Federal Court, is clearly erroneous.

In the first place, the debtor never consented to this "final order". True, it was made on notice to the debtor, but its consent was never given. Therefore, there was, at most, only a technical default in making opposition to the application. And its opposition, even if it could be interposed, would have possesed no meaning or significance at that time. For the primary purpose of that "final order" was to appoint the Mortgage Corporation of New York as successor "trustee" to the Superintendent of Insurance in the administration of the defunct and insolvent guaranty company. So far as the debtor was concerned it did not matter who was the trustee of the mortgage. The purpose of serving notice on the debtor was to apprize it that, after the entry of the "final order", it was to thereafter recognize and do business with only the Mortgage Corporation of New York as successor trustee and representative of the certificate holders who had claims against the insolvent guaranty company. And since the debtor has no real standing in Schackno proceedings, the notice to the debtor could possess no legal implications, or invoke an estoppel on its part.

Secondly: the reservation of jurisdiction by the state court was over the "trust estate", not over the debtor or

its property. The "trust estate", consisted of a bond and mortgage wherein the holders of participation certificates were interested. The purpose of reserving jurisdiction over such "trust estate" was to prevent the Schackno trustee from prejudicing or compromising in any possible way the rights of certificate holders in such bond and mortgage. Thus Paragraph III of the Declaration of Trust (R. 26) provides that

> "The Trustee shall not extend any bond and mortgage, reduce the rate of interest, release any property from any mortgage except as authorized by the terms thereof or the order above referred to, nor sell the securities or the property covered thereby, *without the permission of the Court* * * *;" (Italics supplied.)

Thirdly: the open door allegedly extended to "any other interested party" in said "final order" was not intended to apply to the debtor. As we have shown, the entire proceedings were not intended to apply to the debtor. That is illustrated by the absence of a statute similar to Chapter 290, New York Laws of 1935, (*Section* 1757 of McKinney's Unconsolidated Laws of New York) and Chapter 906, New York Laws of 1934 (*Section* 1801 of McKinneys Unconsolidated Laws of New York). The first statute, Chapter 290 of New York Laws of 1935 was intended to apply to proceedings initiated by Schackno Trustee. The second statute, Chapter 906 New York Laws of 1934, was intended to apply only to proceedings initiated by certificated holders. But there is no similar section providing for a debtor's petition. On this score, the Schackno and Mortgage Commission Acts are significantly silent.

The phrase, "any other interested party" was in reality an invitation intended only for certificate holders

to come to the state court and to lay their grievances before it so that proper supervision could be had of their "trust estate". For certificate holders have had many grievances against Schackno trustees for such practices as 1. paying overriding commissions on leases, (*Matter of Bond & Mortgage Guarantee* Supreme Court, New York County, Special Term Part I, McLaughlin, J., New York Law Journal, June 28, 1941) 2. paying commissions on lease renewals, (*Matter of Lawyers Title & Guarantee Company,* (49 West 72nd Street) Supreme Court, New York County, Special Term Part I, McLaughlin, J., New York Law Journal, November 5, 1941) 3. paying premiums on agent's fidelity bonds out of the trust-estate, (*Matter of Brooklyn Trust Company,* Supreme Court, New York County, Additional Special Term, Noonan, J., New York Law Journal, April 25, 1940) 4. paying lawyers for work the trustees should do, (*In re: Lawyer's Title & Guarantee Company,* Supreme Court, New York County, Special Term Part I, McLaughlin, J., New York Law Journal, June 28, 1941) 5. paying for a servicing agent in addition to a managing agent, (*Matter of Lawyer's Mortgage Company,* (55 East 86th Street) Supreme Court, New York County, Special Term Part I, McLaughlin, J., New York Law Journal, July 9, 1941) 6. paying two sets of lawyers, (*Matter of Lawyer's Title & Guarantee Co.,* Mortgage No. 438385, Supreme Court, New York County, Special Term Part I, McLarghlin, J., New York Law Journal, June 2, 1941) and similar offenses.

Practices of these kinds were frowned upon in State Schackno proceedings. Frequently, the state courts, on their own initiative, surcharged Schackno trustees for indulging in such practices. Therefore, the invitation "to any other interested party" was extended to the certificate holders for the purpose of enlisting their aid so that the state court might be better able to protect their interests. In this way, the state court justices, who were appointed

to generally supervise Schackno proceedings, became the self-appointed watch-dogs of the interests of the certificate holders, but only as against the practices of the Schackno trustees.

In view of the foregoing, it seems clear that the debtor, having originally no standing in Schackno proceedings, is not compelled to beat down the doors of the State Court in order to gain entrance therein for a hearing on a proposed plan already rejected by a Schackno trustee possessing a selfish interest. And since, in any event, the Schackno proceeding was not instituted for the benefit of the debtor, it has an absolute right to seek admission to the only court in the land where the rights of all parties can be heard at one time.

POINT III.

The doctrine of comity has no application to this case.

It is true that the policy of the Federal Courts is not to extend their jurisdiction over matters equally cognizable by state tribunals. *Shanks* vs. *Basting Manufacturing Co.*, 9 Fed. (2) 116. But if the state tribunal is limited in jurisdiction, or its powers are limited to treat with all problems, in a given case, then the federal court's jurisdiction is exclusive to dispose of the entire cause. *Langnes* v. *Green*, 282 U. S. 531. For the rule permitting a state court to continue jurisdiction is not applicable where exclusive authority is given to the Federal Court. *In re: Prupatto*, 51 Fed. (2) 602.

Bankruptcy is an administrative feature of our law which, possessing uniform application, is a monopoly of the Federal Government. Art. 1, Section 8 (4) of the Constitution. Thus, when any state in the Union enacts an insolvency law, it is limited in application only to its

citizens. Such an insolvency law must give way to the Uniform Bankruptcy Act of Congress. For it

> "is paramount and superior to all state laws upon the subject, and all state insolvency laws are suspended insofar as they relate to the same subject-matter and affect the same persons as the National Bankruptcy Act". *First National Bank of Albuquerque* vs. *Robinson*, 107 Fed. (2) 50, at p. 53.

Even more is it necessary to suspend the operation of a state insolvency law (here the Schackno Act) when it appears that it was not intended to apply to the debtor, or that it was a special type of proceeding applying only to certain interested parties.

Thus, let us assume, arguendo, that in 1934 the debtor had several other classes of creditors.[4] Does it follow that because the debtor and one class of creditors involved themselves in 1934 in that special type of proceeding that the debtor is thereafter to be barred from taking all of its creditors, of every class and description, into the Federal court where all and every of its problems can be considered at one time? To do so would result in judicially enlarging the jurisdiction of that special type of proceeding beyond the limits of the statute which created it. It would also be in direct violation of the rule of law laid down by this court in the case of *John Hancock Mutual Life Insurance Co.* vs. *Bartels*, 308 U. S. 180, where the court held that a debtor should not be charged with bad faith merely because he takes a course provided for him by Congress, Chief Justice Hughes, writing the opinion of the court said:

> "the plain purpose of Section 75 was to afford relief to debtors who found themselves in economic distress

[4] The debtor did then have (R. 79) and even now has several types of creditors (R. 70; 71, 91, 92, 93).

> however severe, by giving them the chance to seek an agreement with their creditors. Subsection (a) to (r) and, failing this, to ask for the other relief afforded by subsection (s)".

Even the Circuit Court of Appeals for the Second Circuit, in the case of *In re: Koch*, 116 Fed. (2) 243, recognized that a

> "debtor has a legal right to have her property administered in bankruptcy".

Since, as we have shown, Schackno proceedings are limited in nature, jurisdiction and safety, and are intended to apply only to a certain special group of creditors, it follows that its operation should be suspended when the Federal Bankruptcy Act is properly invoked.

POINT IV.

Regardless of the personal disqualification of the debtor, it was error to dismiss its petition for reorganization in the interest of creditors.

As shown, a reorganization proceeding under Chapter X possesses many inherent advantages over a possible reorganization under the New York State Schackno Act. Those advantages, so far as the creditors are concerned, would be denied to them merely because it was not they who had invoked their application. This kind of reasoning, we submit, does violence to one of the main purposes of the Bankruptcy Act, *i. e.*, protection of creditor's rights.

Concededly, the interests of creditors are paramount to the interests of stockholders. Why therefore, should their best interests be overlooked, and in this case, re-

jected, because of some alleged personal disqualification on the part of the debtor, a disqualification which in reality does not exist, or if existing is purely technical? Yet that is the holding of the Circuit Court which, we submit, is "basic error". *Opinion of Judge Frank* (R. 116).

The Circuit Court dismissed the debtor's petition on the theory of an election of remedies, and that the debtor, having already made its election, could not now be heard to complain. But, as Judge Frank wrote in his dissent,

> "that harsh doctrine is fast becoming weaker even in its traditional strongholds and I cannot acquiesce in an attempt to import it into the streamlined procedure of the Chandler Act. A Chapter X procedure is not a piece of litigation in which the debtor is one of the contending parties, a lawsuit in which it seeks relief against someone else" (R. 125).

and further

> "Even if the doctrine were applicable I cannot understand why any such election of remedies by the debtor should be determinative of what is for the best interests of the creditors. Again, viewing the situation realistically, it is obvious that the certificate holders themselves have not, in any real sense, elected in favor of the state court proceeding" (R. 125).

As shown, neither the debtor, nor the certificate holders ever elected in favor of the state court proceedings. The creditors, like the debtor, were dragged into it, not of their own choice, but because of the insolvency of the Bond & Mortgage Company. To therefore deny certificate holders the benefits of the National Bankruptcy Act, merely because they did not possess the initiative to

invoke it, is a holding which ignores the historical facts of the last decade.

> "Anyone familiar with the realities of corporate reorganizations * * * knows that scattered individual security holders, such as the individual certificate holders in this case, are not at all informed as to their rights", * * * and "ignorant of their theoretical rights, as most such security holders are, they seldom exercise them, but, instead, usually go along with whatever proceedings have already been instituted" * * * Indeed, it was the "well-known inertia of such security holders which led to the enactment of many of the provisions of Chapter X" *Opinion of Judge Frank* (R. 120).

And this court has held in the recent case of *Securities & Exchange Commission* vs. *U. S. Realty & Improvement Co.*, 310 U. S. 434, that one of the principal purposes of a proceeding under Chapter X was to provide "detailed safeguards designed to protect the interests of public investors".

The Circuit Court, however, because of an alleged disqualification on the part of the debtor, would defeat the best interests of the creditors. This would be in direct violation of the firmly established rule of law "that the real purpose and intent of the legislative body must prevail over the literal import of the words used". *Securities & Exchange Commission* v. *U. S. Realty, supra.* It would thus produce a result which Judge Clark, in his *Paloma* dissent, *supra*, describes as follows:

> "I cannot avoid the conviction that we are substituting an inadequate state proceeding for the carefully safeguarded proceedings in reorganization devised by Congress for cases such as this, where the public interest may be protected by the public agency of the Securities & Exchange Commission".

Judge Frank, in his dissent in the court below, said that

> "even if it could be said that the certificate holders had acquiesced in the prior proceedings, nevertheless, no theory of election or estoppel should control since, under clause (4) the inquiry must be what is for their best interests" (R. 125-126).

Therefore,

> "the more the bad faith of the debtor and those confederating with it in such circumstances, the more reason the bankruptcy courts should take jurisdiction. * * * The interests of the security holders in a successful and needed rehabilitation should be deemed superior to the possibly questionable motives of the debtor" (R. 124).

Since, in this case, there is no suggestion of or justification for ascribing sinister or unfair motives on the part of the debtor in filing its petition, the error in the holding of the Circuit Court becomes a grevious one, which in the interests of the creditors alone, requires a reversal.

CONCLUSION.

The order of the Circuit Court should be reversed and order of the District Court affirmed.

Respectfully submitted,

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